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Overcoming the Business Judgment Presumption in American Corporation Law

An Analysis of the Business Judgment Rule and its Raison d'être

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Abstract

Taking business decision is a risky business. When conducting their tasks, corporate decision makers will have to make decisions that involve the balancing of risks and benefits for the corporation. It is more or less inevitable that some of these decisions will turn out to be detrimental to the corporation. The prevalent opinion (in courts and elsewhere) has therefore been that it would be unfavorable if good-faith business judgment was to be re-examined, with the favor of hindsight, by courts. The business judgment rule, an overarching and rebuttal presumption shielding American corporate decision makers from personal liability and insulating directorial decision-making from judicial review, has for a long period of time served this purpose.

This thesis will explain and examine both the business judgment rule as such and how the rule is developing over time. By reviewing the *In re Walt Disney Co. Derivative Litigation* and *Smith v. Van Gorkom*, the debates that these cases led to and the ultimate consequences of these cases, this thesis will argue that courts should reconstrue the business judgment rule. The judicial re-examination of for example decisions constituting apparent business folly (such as in *Schlensky v. Wrigley*) and decisions which a corporate manager *should be able to understand* to be detrimental to the corporation (such as Michael Ovitz's non-fault termination provisions in the *In re Walt Disney Co. Derivative Litigation*), should not be too lenient because of the court's favor of hindsight. Corporate decision makers should be able to foresee the consequences of their decisions in these cases and courts should be less willing to forgive the decision makers.

This thesis will commence at a basic level by explaining and discussing agency problems, fiduciary duties (mainly the duty of care) and executive compensation. The thesis will therefore also serve as an introduction to some parts of American corporation law.

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Abbreviations

ABL	Aktiebolagslag (2005:551)
ALI Principles	The American Law Institute's Principles of Corporate Governance: Analysis and Recommendations (as approved in 1993)
BOD	Board of Directors
CEO	Chief Executive Officer
CFO	Chief Financial Officer
COO	Chief Operating Officer
Del. GCL	Delaware General Corporation Law
IC	Indiana Code
JLR	Journals & Law Reviews
MBCA	Model Business Corporation Act (as approved in 1984, with revisions through 2002)

1 INTRODUCTION

1.1 Background

The centralized management structure of corporations is the source of several judicial problems in American corporate law. The most apparent ones are probably the agency problems that arise when ownership and control of a corporation are separated – leaving shareholders in need of protection against opportunistic directors' misconduct. One means of protection that American corporation law affords shareholders are fiduciary rules – prescribing judicial review of a BOD's decision-making and oversight functions with a possibility to impose personal liability if the corporate decision makers misbehave. However, reviewing and constraining corporate decision makers with a permanent threat of personal liability has its disadvantages. The decision-makers might become overly risk averse – which is detrimental to the corporation as a whole – and there is a ubiquitous risk that qualified business people might decline to serve on corporate boards because they consider the risk of getting imposed with personal liability to be too high. For these, and other, reasons corporate decision-makers also are in need of protection.¹

The well-known (some might even say notorious) business judgment rule² is a controversial part of American corporation law. This overarching presumption, which constrains the fiduciary duty of care, shields corporate decision makers³ extensively from personal liability and insulates directorial decision-making from judicial review. It is up to the plaintiff shareholder, who is suing a director for breaching the duty of care, to overcome the presumption. Unless the plaintiff is able to do so courts will not interfere with the business decision and therefore no liability will be imposed on management – if the decision can be attributed to *any* rational business purpose – even if in hindsight the business decision proves to be detrimental to the corporation.

¹ It should be noted that the protection of corporate directors was discussed as early as 1919 in the famous case *Dodge v. Ford Motor Co.*, 204 Mich. 459, 170 N.W. 668 (1919) – “*courts of equity will not interfere in the management of the directors unless it is clearly made to appear that they are guilty of fraud or misappropriation of the corporate funds, or refuse to declare a dividend when the corporation has a surplus of net profits which it can, without detriment to its business, divide among its stockholders, and when a refusal to do so would amount to such an abuse of discretion as would constitute a fraud, or breach of that good faith which they are bound to exercise towards the stockholders*”.

² Hereinafter *the business judgment rule*, *the business judgment presumption* or *the rule*.

³ According to most statutes both directors and officers are shielded.

In our days of corporate scandals the rationales for the rule have been heavily questioned. One reason for this is because of how corporate decision makers are today given an extensive protection above that of the rule. Corporate managers may for instance be protected through;

- (1) provisions in the corporation's bylaws (stipulating that the corporate managers will not be held liable for damages if breaching their fiduciary duty of care);
- (2) indemnification and;
- (3) insurances.

At times when corporate decision makers have been held liable for rational business decisions, for example in *Smith v. Van Gorkom*⁴, corporate America has been flabbergasted and in the wake of cases like *Smith v. Van Gorkom* the protection of corporate decision makers has expanded greatly. As mentioned above, there is a risk that corporate directors might become risk averse without an extensive protection (a situation that is not only disadvantageous for corporate decision makers but also for the corporation as a whole). On the one hand, there are arguments that the business judgment rule has become superfluous. On the other hand, there are arguments that the rule is a necessary part of the protection of corporate decision makers.

1.2 Purpose

The business judgment rule is widely discussed and highly controversial. However, both the discussion about the rule and the rule as such might be difficult to understand – especially for non-Americans (that might not have a corresponding rule in their own legal system).

The primary purpose of this thesis is to;

- (1) describe and explain the business judgment rule (mainly for a Swedish audience) – both concerning how the rule is developing and the on-going discussion about the rule's *raison d'être* and;
- (2) discuss whether or not; (a) the business judgment rule (thanks to new statutory protections) has become superfluous; (b) the rationale for the business judgment rule has become unsatisfactory. Based on these two discussions the main analysis of this thesis will be to examine whether or not the business judgment rule should be reconstrued (or maybe even removed).

⁴ *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

To be able to achieve its purpose this thesis will discuss fiduciary duties in general and the duty of care (and of course the business judgment rule) in particular. By dismantling the rule and analyzing its elementary components this thesis will try to explain and describe the rule in a pedagogical way leading up to the conclusive analysis.

1.3 Methods, Materials and Disposition

As this thesis deals with American corporation law a departure from traditional Swedish judicial method – using the sources of law in the following order; (a) legislation; (b) case law; (c) doctrine and; (d) preparatory work – has been done. Opposed to the *civil law* system used in Sweden, a *common law* system is used in the United States. In *common law* countries the primary source of law is court decisions (whilst statutes to some extent are seen as incursions into the *common law* and therefore are interpreted narrowly). For this reason the methodological approach, to the subject of this thesis, has been of a *common law* nature – giving greater emphasis to the analysis of legal cases than to the analysis of statutes. The statutes being treated by this thesis are primarily the MBCA and the Del. GCL.⁵

The material that has been used when writing this thesis has mainly been doctrine dealing with similar fields of subject. Articles and case law analyses from the JLR database have been of the utmost importance. This database is considerably more up-to-date than corresponding literature dealing with the same subject matter. Since the business judgment rule has become so widely discussed I have been able to find articles about it written by American law firms. Some of these articles have also been used as a source of information.

This thesis commences at a basic and overarching level where the most central concepts and theories are introduced and discussed. Thereafter the thesis will narrow its focus until it finally reaches the concluding question which will be analyzed in *Chapter 6 Reconstructing the Business Judgment Rule*. In the beginning of the thesis some general characteristics of American corporation law will be highlighted. This will facilitate the understanding of the narrower analyzing parts of the thesis.

⁵ See *Chapter 1.4 Delimitations*.

1.4 Delimitations

The underlying foundation for the subject of this thesis is corporate fiduciary duties⁶. This thesis will deal with the fiduciary duties in a going concern. According to fiduciary analysis fiduciary duties may be separated into two different kinds of fiduciary duties (which the corporate managers owe to their corporation); (a) the duty of care and; (b) the duty of loyalty. These two duties summarize standards for judicial review of corporate decision-making and fiduciary activities. This thesis will have its main focus on the duty of care and more specifically on the business judgment rule. The duty of loyalty will only be examined indirectly in those chapters focusing on executive compensation.

In an attempt to keep the focus of the thesis I have chosen to describe as few as possible adjoining and ubiquitous facts and circumstances of American (corporation) law. I do understand the downside of this delimitation (mainly because this thesis first and foremost is written for a Swedish audience (which probably would need this information to be able to get a more all-embracing understanding of American corporation law as a whole)). However it would be impossible to explain all the basics and sidetracks needed in a thesis of this proportion and therefore I have tried to keep a more stringent focus instead. I do invite the reader to find more information about adjoining facts elsewhere.

In *Chapter 4* executive compensation will be introduced. The main purpose of this chapter is to facilitate the understanding of the following *Chapter 5* where the *In re Walt Disney Co. Derivative Litigation* is discussed. For this reason this thesis will not explain executive compensation in detail but rather introduce some basic characteristics.

American legislation is divided into federal and state law. This thesis has its main focus on the Del. GCL and the MBCA. The reason for this delimitation is that the Del. GCL and the MBCA must be considered to be the cornerstones of American corporation law. In those few cases when other state laws are discussed it will be almost exclusively specific sections that are analyzed for comparative purposes.

⁶ A short description of fiduciary duties is that they are duties that corporate fiduciaries owe to their company, often based on the premise that the fiduciaries shall try to act in the best interest of the corporation. Fiduciary duties are a particularly important (and infected) part of the American corporation law. The duties arise as a result when the authority to manage and supervise the corporation's business and affairs is delegated to directors and the duties serve as a kind of protection for shareholders' investments and rights in the company at several occasions. See Palmiter, A. R., *Corporations Examples & Explanations*, Aspen Publishers, New York 2006, at 188.

Concerning the case law being referred to in this thesis the main focus will be on two cases; (a) *Smith v. Van Gorkom* and; (b) *The In re Walt Disney Co. Derivative Litigation*. The thesis will refer to several other cases but it is only these two that will be examined thoroughly.

This thesis is restrained from extensive comparative studies between American and Swedish corporation law. Instead the focus will, almost, solely be on American corporation law. However, some brief comparative notes will be made with the purpose to facilitate the understanding of the subject for Swedish readers. This thesis will compare some aspects of Swedish corporation law to the American ditto but it will not describe Swedish corporation law to any wider extent.

2 CORPORATE FIDUCIARY DUTIES

2.1 Introduction

The corporation has a centralized management structure and all corporate powers shall be exercised by or under the authority of (and the business and affairs of the corporation managed by or under the direction of) its board of directors.⁷ This fundamental principle in corporate law might seem straightforward and obvious, but the displacement of corporate powers (from shareholders to directors) is in fact the source of a range of problems leaving shareholders in need of protection against opportunistic directors' misconduct.

Basically fiduciary duties can be said to be one of three⁸ principal sources of protection that American corporation law affords to shareholders. Fiduciary duties are important for a number of reasons in this aspect.⁹ In the context of this thesis, fiduciary duties are important because it affords a basis for shareholders to recover for the corporation's amounts diverted from the corporation through different types of managerial misconduct.¹⁰

As mentioned above,¹¹ different types of fiduciary duties exist within several areas. Two of the most fundamental duties of fiduciaries in general (and of corporate directors particularly) are the duty of care and the duty of loyalty.¹² Broadly speaking, the latter addresses fiduciaries' conflicts of interest and requires the decision makers to put the corporation's interest ahead of their own, whilst the former prescribes judicial review of board decision-

⁷ Del. GCL §141 and MBCA §8.01(b).

⁸ The other two being; (1) the shareholder's right to vote his or her stock and; (2) the shareholder's right to sell the stock. (All three are principally enforced judicially through shareholder-initiated lawsuits).

⁹ For example; (1) they protect the right to vote against manipulation that may disarm it (see *e.g. Blasius Indus. v. Atlas Corp.* 564 A.2d 651 (Del. Ch. 1988)) and; (2) they may protect the mechanism that permits hostile corporate takeovers from manipulation by incumbent managers seeking to protect *status quo* (see *e.g. Revlon v. MacAndrews & Forbes Holdings, Inc.* 506 A.2d 173 (Del. 1986) and *Paramount Communications Inc. v. QVC Network, Inc.* 637 A.2d 34 (Del. 1993)).

¹⁰ Allen, W. T., *The Corporate Director's Fiduciary Duty of Care and the Business Judgment Rule Under U.S. Corporate Law*, in *Comparative Corporate Governance*, (Hopt, K. J., *et al.* eds.), Oxford University Press, Oxford 1998, at 313-314.

¹¹ See *Chapter 1.4 Delimitations*.

¹² Allen, W. T., *supra* note 10, at 315.

making and oversight – a duty of a director or officer to exercise the care of an ordinarily prudent person confined by the business judgment rule.¹³

As a Swedish law student it is interesting to note that, whilst American law uses two separate duties (the duty of care and the duty of loyalty), Swedish law places both duties under a general culpation rule (Swedish: “allmän culparegel”) in the Swedish General Corporation Act (the ABL) 29:1. This rule prescribes that incorporators, members of the board and CEOs who intentionally or by negligence cause the company any damage when carrying out their duties shall remedy this damage – “[e]n stiftare, styrelseledamot eller verkställande direktör som när han eller hon fullgör sitt uppdrag uppsåtligen eller av oaktsamhet skadar bolaget skall ersätta skadan”. According to the government bill *Proposition 1975:103 Om Förslag till ny Aktiebolagslag, m.m.*, at 540, this means that incorporators, members of the board and CEOs shall adhere to the same degree of prudence that could be required from a fiduciary in general. According to Dotevall this rule is both comparable to and most likely deriving its origins from the business judgment rule¹⁴ – “[v]ad beträffar svensk rätt kan den formella aktsamhetsstandarden sägas vara jämförbar med de krav som ställs i amerikansk rätt. [Det formella aktsamhetskravet lämnar] ett stort utrymme för beslut rörande bolagets affärsverksamhet, på ett sätt som liknar den amerikanska the business judgment rule”¹⁵.

2.2 Agency Problems, Limited Liability and Fiduciary Duties

One important reason why legislation around fiduciary duties is necessary can be found in the so-called *Berle-Means paradigm* and its identification of the (inevitable) separation of ownership and control in the modern corporation.¹⁶ It is possible to identify at least three different agency problems in today’s corporations;

- (1) there is a risk that a conflict will arise between the owners of the corporation and the corporation’s appointed managers (this is the pertinent agency problem in this thesis);
- (2) there is a risk that a conflict will arise between (controlling) majority shareholders and (non-controlling) minority shareholders and;
- (3) there is a risk that a conflict will arise between the corporation itself and third parties in contact with the corporation (for example creditors, employees and customers).

¹³ *Id.* at 315-316, Palmiter, A. R., *supra* note 6, at 192, 201 and 231 and Hill, C. A., Disney, Good Faith, and Structural Bias, 32 J. Corp. L. 833 (2006), at 835-837.

¹⁴ See Chapter 3.2.2 *The Business Judgment Rule*.

¹⁵ Dotevall, R., *Bolagsledningens Skadeståndsansvar*, Nordstedts Juridik, Stockholm 1999, at 77.

¹⁶ Bratton, W. W., Berle and Means Reconsidered at the Century’s Turn, 26 J. Corp. L. 737 (2001), at 759-760.

In the first case, where the owners are principals and the managers are agents, the main problem for the owners is how to make sure that the corporation's appointed managers are responsive to the owners' interests rather than to their own personal interests.¹⁷

According to Berle and Means, three components of ownership have been separated through the introduction of the publicly traded corporation. The first, *risk capital supply*, is left in the hands of the shareholders, while the other two, *control over the company* and *authority to bind the company*, are left in the hands of the managers.¹⁸ As managers generally have access to much more information than owners, this separation leads to a lop-sided allocation of the access to relevant corporate information. The allocation is not strange, erroneous or dubious in itself, but it leads to a situation where shareholders must ensure themselves against any opportunistic misbehavior by corporate managers.¹⁹ The expenditures for this control, the so called *agency costs*, often become extensive and quite frequently companies try to reduce these agency costs for example by binding their directors to the company (e.g. by stock option plans) to create a connection between the company's and the directors' welfare and interests. Thus, the managers get an incentive to try to obtain what is in the interest of the owners.²⁰

Fiduciary duties derive from the inevitable discrepancy that arises when the risk-taking (of investors) and the decision-making (of directors) are separated – i.e. a typical agency problem. A solution to this discrepancy is to find a balance between directors' discretion and directors' liability for their actions. On the one hand, directors are specialized in performing their specific assignment – to handle the business of the company. This is an indication that the directors should be given considerable discretion (as it will give the managers the best chance of acting as efficiently as possible). If shareholders and courts are given too many means to review and second-guess the actions of corporate managers this efficiency would be undermined (which would be unfavorable to the company). For this reason the everyday decision-making of the corporation should be left to directors, without the peril of review and liability – except in those specific situations where liability is absolutely necessary. On the other hand, the mere fact that the management of the company is entrusted to a group of non-owners indicates a need for means to review and enforce liability for misconduct. It is always a risk that directors, as non-owners, have an incentive to be lazy, unreliable and to be too reckless with the resources and assets of the corporation. For this reason judicial intervention ought to be possible if and when directors exceed their powers or duties. The use of fiduciary rules is one way to try to solve these problems and thereby to try to minimize agency-costs.²¹

¹⁷ Kraakman, R. R., Davies, P., Hansmann, H., Hertig, G., Hopt, K. J., Kanda, H., Rock, E. B., *The Anatomy of Corporate Law A Comparative and Functional Approach*, Oxford University Press, Oxford 2004, at 22.

¹⁸ Lecture in American Company Law, 2007-08-07, Lecturer: Elif Härkönen.

¹⁹ Kraakman, R. R. *et al.*, *supra* note 17, at 21.

²⁰ Kraakman, R. R. *et al.*, *supra* note 17, at 26-27.

²¹ *Id.* at 23-24, and Palmiter, A. R., *supra* note 6, at 189.

It has been widely discussed to whom directors owe their fiduciary duties. In the famous case *Dodge v. Ford*²² the Michigan Supreme Court asserted that fiduciary rules derive its origin from *the shareholders wealth maximization theory*, according to which the primary aim for all fiduciary rules is the shareholders' interest in the corporation.²³ This implies that the corporation's other constituents (*e.g.* creditors, bondholders and employees) are limited to contractual and other legal rights. Today, most instances allege that, as long as the corporation is solvent, corporate managers owe their fiduciary duties to equity shareholders. If the business becomes insolvent the corporate managers owe their fiduciary duties to the corporation's creditors instead.²⁴ As this thesis focuses on going concerns, the relationship between corporate managers and shareholders is of the greatest relevance here.²⁵

²² *Supra* note 1.

²³ The court held that Henry Ford owed a duty to the shareholders of the Ford Motor Company to operate the corporation's business for profitable purposes (as opposed to charitable purposes).

²⁴ Kraakman, R. R. *et al.*, *supra* note 17, at 88-89, Gevurtz, F. A., *Corporation Law*, West Group, St. Paul Minn. 2000, at 304-313 and Palmiter, A. R., *supra* note 6, at 189-191.

²⁵ See *Chapter 1.4 Delimitations*.

3 THE DUTY OF CARE AND THE BUSINESS JUDGMENT RULE

3.1 Introduction - Standards of Care

When corporate managers carry out their leading functions in a corporation they are subject to both statutory and common-law standards of care. The statutory standards are regulated at state level, entailing diverse regulations in different states.²⁶

For those states that have adopted the MBCA, §8.30 delineates the standards of conduct for directorial behavior by concentrating on both the manner in which directors perform their duties and the level of performance expected of them in managing the business dealings of the corporation. The section implies that each member of the BOD must carry out their duties “*in good faith*” and act “*in a manner the director reasonably believes to be in the best interest of the corporation*”.²⁷

A similar principle is found in the *ALI's Principles* §4.01(a), according to which; “*a director or officer has a duty to the corporation to perform the director's or officer's functions in good faith, in a manner that he or she reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances*”.

When carrying out their decision-making and reviewing functions the corporate directors, on a collective level, is anticipated to become sufficiently informed with “*the care that a person in a like position would reasonably believe appropriate under similar circumstances*”.²⁸

In Delaware no support of statutory requirements is needed, but a similar standard, presuming that directors take rational business decisions, is stipulated by common-law. The Delaware Supreme Court has declared that it is up to the plaintiff, who opposes a business decision, to show that “*the directors failed to act (a) in good faith, (b) in the honest belief that the action taken was in the best interest of the company, or (c) on an informed basis*”.²⁹ Absent an abuse of discretion the decision will be respected by the courts. The burden is on the party

²⁶ Palmiter, A. R., *supra* note 6, at 201.

²⁷ MBCA §8.30(a).

²⁸ MBCA §8.30(b).

²⁹ *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

challenging the decision to establish facts rebutting the presumption. Or in other words, if the plaintiff does not succeed in proving one of these three requisites, the BOD will not be liable as a result of their decision and no court will second-guess the decision.

3.2 The Duty of Care and the Business Judgment Rule Defined

3.2.1 The Duty of Care

The duty of care can be described as *a general instrument of corporate governance* which establishes a “*minimum quality threshold*”³⁰ for the attentiveness and prudence that a BOD must abide by when performing their decision-making and supervisory functions.³¹ In other words the duty of care addresses the attentiveness and prudence of managers in performing their business decision-making and supervisory functions.

The duty of care has three separate facets;

(1) *good faith* – according to which a director must; (a) be honest; (b) not have a conflict of interest and; (c) not condone or approve illegal activity;

(2) *reasonable belief* – which deals with the substance of a director’s decision-making. This standard embodies the *waste standard* and implies that board decisions must be congruent with the corporation’s interests and;

(3) *reasonable care* – which deals with the procedural aspects of board decision-making and oversight. When condoning their decision-making, monitoring and supervising management corporate managers are required to be sufficiently informed and to have at least minimum levels of skill and expertise.³²

To define and enforce a standard of this kind is not uncontroversial. Two fundamental counter-arguments against doing so are; (a) that it is practically impossible for a court to evaluate a business decision *ex post*; (b) that a standard imposing liability could possibly make directors overly risk averse *ex ante*.³³ Commentators have tried to describe the perils; “*a legal standard of liability that penalizes good faith business judgments where failure ensues eliminates a core protection and incentive for entrepreneurial action [...] [t]his could effe-*

³⁰ Kraakman, R. R. *et al.*, *supra* note 17, at 52.

³¹ Palmiter, A. R., *supra* note 6, at 192.

³² All of the three facets will be discussed more below.

³³ Kraakman, R. R. *et al.*, *supra* note 17, at 52.

ctively freeze industrial growth in the U.S. indefinitely”.³⁴ The business judgment rule acts as a counterbalance to this “threat”.

3.2.2 The Business Judgment Rule

The business judgment rule is an overarching and rebuttal presumption that shields directors from personal liability and insulates directorial decision-making from judicial review. The presumption implies that corporate directors and officers do not breach their fiduciary duty of care,³⁵ and that they carry out their functions in good faith, after sufficient investigation and for acceptable reasons.³⁶ Or in other words, corporate directors and officers are presumed to have made a sufficient effort to make their decisions on a well-informed basis.³⁷ In the opinion to *Grobow v. Perot*³⁸ a test was constructed as a guideline for satisfaction of the business judgment rule. According to this test directors in a business shall; (a) act on an informed basis; (b) act in good faith; (c) act in the best interests of the corporation; (d) not involve self-interest and; (e) not be wasteful.

It is up to the plaintiff to overcome the presumption.³⁹ Unless the plaintiff is able to do so, the court will not interfere with the business decision and therefore will not impose liability on management – provided that the decision can be attributed to any rational business purpose – even if the decision proves to be detrimental to the corporation.⁴⁰ The business judgment rule applies no matter how “*controversial, unpopular or even wrong such a decision might turn out to be*”⁴¹ and under the business judgment rule, directors will not even be held liable for

³⁴ Hiler, B. A., Raphaelson, I. H., Baird, E. H., Criminalizing Business Judgment Could Stagnate U.S. Economy, Legal Backgrounder (Wash. Legal Found., Washington, D.C.), June 7, 2002, at 2. (Available at <http://www.wlf.org/upload/060702LBHiler.pdf>).

³⁵ Palmiter, A. R., *supra* note 6, at 203.

³⁶ In discharging his board and committee duties a director may “*rely on information, opinions, reports or statements [...] prepared or presented by*”: (1) other officers or committees of the BOD of which the director is not a member; (2) officers and employees of the corporation whom the director reasonably believes to be reliable and competent; (3) outside experts (e.g. legal counselors and public accountants). See Del GCL §141(e) and MBCA §8.30(c)-(e).

³⁷ Palmiter, A. R., *supra* note 6, at 192 and Svernlöv, C., Ansvarsfrihet Dechargeinstitutet i Svensk Aktiebolagsrätt, Nordstedts Juridik, Stockholm 2007, at 135.

³⁸ *Grobow v. Perot*, 539 A.2d 180 (Del. 1988).

³⁹ See Chapter 3.2.3 Overcoming the Business Judgment Presumption.

⁴⁰ The Business Judgment Rule rests on the notion that corporate directors are “*more qualified to make business decisions than are judges*” (*International Ins. Co. v. Johns*, 874 F.2d 1447, 1458 n.20 (11th Cir. 1989)) and that the business decisions of corporate management therefore should not be second-guessed by courts (*Federal Deposit Ins. Corp. v. Stahl*, 89 F.3d 1510, 1517 (11th Cir. 1996)).

⁴¹ *Grobow v. Perot*, 526 A.2d 914, 928 (Del. Ch. 1987).

conduct that is “*undoubtedly imprudent in hindsight*”⁴². This way an extensive protection against personal liability is given to corporate managers.

The rationale⁴³ for the business judgment rule is considered to rest on several grounds, amongst others;

(1) it encourages the BOD to take business risks, liberating them from the constant fear of lawsuits which could affect their judgment. The fact that risk-taking is such a great necessity in the business world (the adage *noting ventured, nothing gained* is rather explanatory) is probably the main justification for the rule;⁴⁴

(2) it avoids judicial meddling. It is specified in the corporate statutes that corporate management is entrusted to the BOD because of their expertise in the field. Judges are not business experts in the same way and should therefore abstain from second-guessing the decisions made by the BOD and;⁴⁵

(3) it encourages qualified business people to become board members. Without an impending risk to be exposed to personal liability in hindsight, qualified persons are given greater encouragement to become corporate directors and officers and to take business risks.⁴⁶

It should be noted that the rule’s protection, which is supposed to encourage corporate managers to take business risks, is also often substantially extended through exculpation provisions in the corporation’s articles, statutory and contractual indemnification and directors’ and officers’ insurances.⁴⁷

The business judgment rule is a broadly adopted judicially-developed concept and its existence has been inferred by both state courts and legislatures. Many state courts⁴⁸ of today apply a business judgment presumption and the Official Comment to *MBCA* §8.31, recognizes the business judgment rule as a “*broad common law concept*”.⁴⁹

⁴² *Potter v. Pohlad*, 560 N.W.2d 389, 393 (Minn. Ct. App. 1987).

⁴³ The rationale for the business judgment rule will be analyzed and questioned further in *Chapter 6 Reconstruing the Business Judgment Rule*.

⁴⁴ See e.g. *Gagliardi v. TriFoods Int’l Inc.*, 683 A.2d 1049, 1052 (Del. Ch. 1996).

⁴⁵ “[D]irectors are, in most cases, more qualified to make business decisions than are judges” (*International Ins. Co. v. Johns*, *supra* note 40).

⁴⁶ *Palmiter, A. R.*, *supra* note 6, at 204.

⁴⁷ *Id.* at 192.

⁴⁸ Back in 2002 at least 25 state courts did so.

⁴⁹ *Hiler, B. A. et al.*, *supra* note 34, at 2.

It is important to remember that the business judgment rule and the duty of care were developed separately. In most states today the two have more or less grown together, with an exception in Delaware where the business judgment rule once arose from case-law.⁵⁰ However, the business judgment rule and the duty of care do not perfectly interlock, which might lead to situations where they work in a contradictory manner. For example, according to the business judgment rule a member of the board can only become liable for *gross negligence*, whilst the duty of care only obliges members of the board to adhere to the level of prudence that an ordinarily prudent person in a similar position and under similar circumstances would adhere to. Since neither the business judgment rule nor the duty of care has been construed to their outermost limits, courts have yet to disentangle this tension. In general, a greater weight has been laid upon the managers' efforts to reach a decision than on the decision's appropriateness in itself when courts have tried the duty of care.⁵¹ When the business judgment rule has been tried, members of the board have not been acquitted if they have not been sufficiently prudent in their decision-making.⁵²

3.2.3 Overcoming the Business Judgment Presumption

3.2.3.1 Introduction

If a shareholder decides to challenge a board decision, courts will place the burden of proof on the challenging shareholder to rebut the business judgment presumption by proving either; (a) fraud, illegality, or a conflict of interest (lack of good faith); (b) lack of a rational business purpose (waste); (c) gross negligence in discharging duties to supervise and to become informed.⁵³ This corresponds to the standards of liability specified in the *MBCA* §8.31.⁵⁴ If a court finds that the challenger has been able to rebut the presumption, any director who has participated in the decision is liable for breaching the duty of care.

⁵⁰ Taylor, C. R., *The Inadequacy of Fiduciary Duty Doctrine: Why Corporate Managers Have Little to Fear and What Might Be Done About It*, 85 Or. L. Rev. 993 (2007), at 1010 and 1019-20.

⁵¹ This is in accordance with the Official Comment to the *MBCA* §8.30, which explains: "[i]t [MBCA §8.30] sets forth the standard by focusing on the manner in which the director performs his duties, not the correctness of his decisions".

⁵² Svernlöv, C., *supra* note 37, at 136.

⁵³ Palmiter, A. R., *supra* note 6, at 205.

⁵⁴ According to the *MBCA* §8.31 a director can become liable for; (a) an action not in good faith; (b) a decision which the director did not reasonably believe to be in the best interests of the corporation or as to which the director was not adequately informed; (c) conduct resulting from the director's lack of objectivity or independence, unless the director proves that he believes that the conduct actually was in the corporation's best interests; (d) a sustained failure to be informed in discharging the director's oversight functions; (e) receiving an improper financial benefit.

3.2.3.2 Not in Good Faith

The first way a challenger can rebut the business judgment presumption is by proving that the directors have not acted in good faith.

The function of the *good faith principle* in corporate law is not perfectly clear, and it is neither defined by the Del. GCL nor by any judicial precedent. However, the Delaware Supreme Court has acknowledged good faith in its (corporate law) opinions, occasionally ranking it alongside the traditional fiduciary duties of care and loyalty and thereby implying that good faith is to be given a role in fiduciary duty analysis equal to the other two.⁵⁵

Furthermore, the Delaware Supreme Court has acknowledged that good faith is an amorphous principle, having no content of its own, but rather varying “*somewhat with the context*”⁵⁶. In corporate law, this tends to lead to a situation where good faith restates either the duty of care or the duty of loyalty. For example; “[i]f one thinks of good faith as doing the job right or adequately fulfilling one’s fiduciary obligations, then it drifts towards the sort of prudential issues ordinarily addressed under the duty of care”⁵⁷.

In addition to this, good faith has also been suggested to simply be a shortcut for referring to the welfare-maximization goals underlying corporate law.⁵⁸

Hence, good faith seems not to be a fixed doctrine in corporate law but rather one that changes over time, adapting itself to new arising needs.

There are three different ways for a challenger to show that a director has not acted in good faith, and thereby rebut the business judgment presumption, by proving either;

(1) that the action was *fraudulent* – if the challenger is able to prove that a director has acted fraudulently the latter loses his business judgment protection and may be held liable for the fraudulent actions. Other actions can be invalidated as well, regardless of fairness, if they have been tainted by the fraud;⁵⁹

(2) an underlying *conflict of interest* – if the challenger is able to prove that a corporate action leads to a personal or financial benefit for a director (i.e. if a personal interest can be shown) the business judgment presumption is rebutted and will not protect either the director from liability or the board’s

⁵⁵ Griffith, S. J., Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence, 55 Duke L.J. 1 (2005), at 3-4.

⁵⁶ *E.I. DuPont de Nemours & Co. v. Pressman*, 679 A.2d 436, 443 (Del. 1996).

⁵⁷ Griffith, S. J., *supra* note 55, at 5.

⁵⁸ *Id.* at 5-6.

⁵⁹ Palmiter, A. R., *supra* note 6, at 206.

approval from review.⁶⁰ The business judgment presumption can also be rebutted if a director approves a corporate action because he is beholden to another person interested in the action;^{61,62}

(3) an *illegality* – if the challenger is able to prove either that a director has approved illegal behavior or that the director has remained intentionally ignorant of such behavior, the business judgment presumption will in all probability be considered rebutted – even if the director was informed and the action in fact ultimately benefited the corporation.⁶³ Two examples of when directors have been considered liable because of corporate illegalities are; (a) when a director paid “hush money” to state officials claiming illegal and profitable operation of a business;⁶⁴ (b) when a business plan that created a strong incentive for employees to commit Medicare and Medicaid fraud was approved by the directors.⁶⁵ Attempts to regulate corporate illegalities by means of fiduciary rules have produced a somewhat uncomfortable fit. When corporate decision makers are liable for illegalities under corporate law instead of under substantive law (which has the ability to invalidate the behavior) the possibility to invalidate a behavior is lost and the corporate fiduciary rules become a source for the enforcement of business regulation. This leads to an arising tension⁶⁶ between two facts; (a) that approval of illegalities might actually lead to an increase of the profits of the corporation and; (b) that condoning intentional illegalities is incompatible with non-corporate norms.⁶⁷

⁶⁰ *Id.* at 206.

⁶¹ See for example the MBCA §8.31(a)(2)(iii).

⁶² Palmiter, A. R., *supra* note 6, at 206.

⁶³ *Id.* at 206-207.

⁶⁴ *Roth v. Robertson*, 118 N.Y.S. 351 (Sup. CT. 1909).

⁶⁵ *McCall v. Scott*, 239 F.3d 808 (6th Cir. 2001).

⁶⁶ Courts have recognized this tension today. One example, illustrating the pitfalls of using corporate law to enforce non-corporate legal norms, is *Miller v. AT&T*, 507 F.2d 759 (3d Cir. 1974). In this case it was established that an illegal purpose by itself cannot be a rational business purpose sufficient to trigger a protection through the business judgment rule. The shareholders of AT&T brought a derivative suit challenging AT&T's failure to collect a \$1.5 million debt owed by the Democratic National Committee (DNC). According to the plaintiffs, this failure violated federal campaign finance laws. The Third Circuit alleged that, under corporate norms, the directors' business decision to remit a debt normally was protected. However, the court meant that AT&T's failure to collect the DNC debt could be actionable, if the directors had no “legitimate” business justification aside from illegally seeking political favors for remitting the debt. Hence, the directors of AT&T were not insulated from liability on the ground that the illegal campaign contribution was made exercising business judgment.

⁶⁷ Palmiter, A. R., *supra* note 6, at 206-207.

3.2.3.3 Lack of a Rational Business Purpose

The second way for a challenger to rebut the business judgment presumption is by proving that the board action was irrational – *i.e.* that the director acted without a rational business purpose. A rational purpose test is made and if the challenger is able to prove that the board action wholly lacked business purpose, the action is considered as a *waste of corporate assets* and the business judgment presumption is rebutted.⁶⁸

The waste standard is set remarkably high– to constitute waste the board action must lack *all* rational business purpose and it cannot benefit the corporation in any possible way.⁶⁹ As long as the business judgment is not “*improvident beyond explanation*”⁷⁰ the decision will be protected from review (and the directors will be shielded from liability) – even if a board decision in hindsight seems obviously unwise or imprudent. The reason for why the waste standard is set so high is to prevent good-faith business decisions from being reviewed (even if in hindsight they seem imprudent or unwise). Courts have even showed a willingness to forgive business stupidity, see for example *Schlensky v. Wrigley*⁷¹.

Consequently, a challenger will have a hard time proving waste. There are only a few examples of when good-faith board actions have been found to be *so* imprudent or irrational that the actions have deprived the directors of the protection of the business judgment rule (even in many of these cases it is open to dispute whether the outcome really reflects disinterested misjudgment or if it is rather a matter of courts using the care standard when a conflict of interest is inferred but not proven).⁷² In *Litwin v. Allen*⁷³ the directors of Guaranty Trust were held liable for their approval of stock repurchase agreements in 1929 (subsequent to the stock market crash). The court considered the approval to be “*so improvident, so risky, so unusual and unnecessary to be contrary to fundamental conceptions of prudent banking practice*” that an abstention from second-guessing the decision was impossible. The Guaranty Trust directors, who at the time were considered to be amongst the most experienced banking

⁶⁸ *Id.* at 207-210.

⁶⁹ The latter is defined by the Official Comment to MBCA §8.31(a)(2)(ii) – stating that these are rare cases, where corporation’s best interest is “*so removed from realm of reason*” or director’s belief “*so unreasonable as to fall outside bounds of sound discretion*”.

⁷⁰ *Michelson v. Duncan*, 407 A.2d 121 (Del. 1979).

⁷¹ *Schlensky v. Wrigley*, 237 N.E.2d 776 (Ill, App. 1968). Philip K. Wrigley, the former majority shareholder and dominant member of the board of the baseball team the Chicago Cubs, refused to let the team start to play night time baseball (and installing night lights), instead of daytime baseball, at the Wrigley Field baseball stadium in Chicago. The shareholders challenged the board’s decision alleging that night time baseball would lead to higher attendance at the games and hence increasing the profits. Wrigley opposed the shareholders simply by expressing that “*baseball is a daytime sport*” and that night time baseball might lead to a deterioration of the neighborhood around Wrigley Field. The court chose to dismiss the shareholders complaint and speculated that Wrigley’s anxiety about a deterioration of the neighborhood probably was justified since it could decrease Wrigley Fields property value.

⁷² Palmiter, A. R., *supra* note 6, at 208-209.

⁷³ *Litwin v. Allen*, 25 N.Y.S.2d 667 (Sup. Ct. 1940).

risk managers, could not by any means have been unaware of and should not have been indifferent to the great risks connected with the stock repurchase agreements.

It has yet to be determined whether or not the business judgment presumption protects directors' inaction (*i.e.* their failure to act). For a long time the common view has been that board inaction is protected as long as the failure to act is a conscious exercise of business judgment.⁷⁴ In other words, to stay protected the BOD has to have explicitly considered whether or not they should act in the specific situation, reaching an active decision not to.⁷⁵ *Graham v. Allis Chalmers Manufacturing Co.*⁷⁶ may serve as an example, if a board explicitly considers instituting an antitrust compliance system but then decides not to, because they think it is unwarranted, the good-faith inaction will be protected by the business judgment rule. Thus, according to some court dicta, an actual conscious exercise of business judgment is required to get the protection of the business judgment rule. Unconscious inactions are far more problematic. However, bearing in mind all the things that never appear on the board's agenda (and the board for this simple reason never has the possibility to consider), it is questionable if an actual exercise of business judgment really is required. It seems slightly inconsistent if the board would not be protected by the business judgment rule in these situations.⁷⁷ According to the *MBCA* §8.31(a) and §8.31(a)(2)(iv) “*any decision to take or not to take action, or any failure to take any action [imposes liability only in case of] a sustained failure of the director to devote attention to ongoing oversight of the business and affairs of the corporation, or a failure to devote timely attention [...] by making (or causing to be made) appropriate inquiry, when particular facts and circumstances of significant concern materialize that would alert a reasonably attentive director to the need therefore*”.

3.2.3.4 Gross Negligence When Becoming Informed and When Condoning Supervising Functions

3.2.3.4.1 Introduction

In situations of decision-making, due to the fact that corporate decision makers must make a reasonable effort to inform themselves in their decision-making, challengers have a third way to rebut the business judgment presumption. The main focus is on the procedural aspects of the decision-making, leaning on a presumption that diligent board consideration ensures rational board actions. Today, many courts state that directors' liability is based on *concepts of gross negligence* (*i.e.* liability is imposed only if the director has shown gross negligence or recklessness).⁷⁸ In some statutes this has been codified. One example is the Indiana Code, according to which “[a] director is not liable for any action taken as a director, or any failure

⁷⁴ See for example ALI Principles, comment to §4.01(c).

⁷⁵ Palmiter, A. R., *supra* note 6, at 209-210.

⁷⁶ *Graham v. Allis Chalmers Manufacturing Co.*, 188 A.2d 125 (Del. 1963).

⁷⁷ Palmiter, A. R., *supra* note 6, at 210 and Gevurtz, F. A., *supra* note 24, at 276-278.

⁷⁸ Palmiter, A. R., *supra* note 6, at 210.

to take any action, unless [...] the breach or failure to perform constitutes willful misconduct or recklessness”⁷⁹. The MBCA regulation differs slightly by considering a director as liable if he has not informed himself about a decision “to an extent the director reasonably believed appropriate in the circumstances”⁸⁰.

3.2.3.4.2 *Smith v. Van Gorkom*⁸¹

3.2.3.4.2.1 Introduction

So when is a director considered to be *adequately informed*? One of the most important cases relating to this issue is *Smith v. Van Gorkom*. The case is especially significant because of the Delaware Supreme Court’s demarcation of the requisites for directorial breaches of the duty of care.⁸² The directors of the Trans Union Corporation⁸³ were held personally liable, and hence liable in damages to the plaintiff shareholders, for not being adequately informed when approving the sale of the company in a cash-out merger. Prior to the *Trans Union* decision courts had been reluctant to impose liability for a breach of the duty of care,⁸⁴ provided that the directors acted in good faith, in the best interest of the corporation and that the decisions were not tainted by fraud, illegality or violations. It should be noted that the *Trans Union* case (unlike modern examples like Enron, WorldCom, Tyco International and Adelphia) did not involve any form of loyalty violations, fraud or illegality on the part of the BOD and management. Despite this, as mentioned just above, the court ultimately imposed personal liability in *Smith v. Van Gorkom*.

3.2.3.4.2.2 Background

In the late 1970s Trans Union, a publicly traded company getting most of its revenues from its railcar-leasing business, did not produce an adequate amount of taxable income to claim investment tax credits (which were generally available to other companies in the same field) leaving Trans Union with a disadvantage in not being able to match the competitors’ prices. Two proposals on how to end this critical situation were submitted at a management meeting in August 1980. The first suggested a merger between Trans Union and a larger company, whilst the second suggested a leveraged buy-out (at which the directors would buy Trans Union from the shareholders using the corporation as collateral for a loan). Donald Romans,

⁷⁹ IC §23-1-35(1)(e)(2).

⁸⁰ MBCA §8.31(a)(2)(ii)(B).

⁸¹ *Supra* note 4. The case is also known as the *Trans Union* case. Hereinafter both names will be used.

⁸² Shu-Acquaye, F., *Smith v. Van Gorkom Revisited: Lessons Learned In Light Of The Sarbanes-Oxley Act Of 2002*, 3 DePaul Bus. & Com. L.J. 19 (2004), at 19.

⁸³ Hereinafter *Trans Union*.

⁸⁴ See for example *Dodge v. Ford Motor Co.*, *supra* note 1, *Schlensky v. Wrigley*, *supra* note 71, and *Joy v. North*, 692 F.2d 880 (2d Cir. 1982).

the CFO of Trans Union, presented some rough calculations of a fair price value of the shares in case of a leveraged buy-out situation in the \$50 to \$60 span. The slightly historical depressed market price of Trans Union shares was at the time about \$40. However, both proposals got opposed by Jerome W. Van Gorkom, the CEO and chairman of the board of Trans Union.

In September the same year (without consulting either his board members or the senior management of Trans Union) Van Gorkom met Jay A. Pritzker, a corporate takeover specialist who controlled the Marmon Group (and who was also a social acquaintance to Van Gorkom). Van Gorkom proposed a sale of Trans Union to the Marmon Group at a price of \$55 a share. Pritzker accepted this offer and together they worked out a deal during the next couple of days. Pritzker demanded a response to the offer from the board of Trans Union by September 21 (leaving Van Gorkom only three days to consult with his board). On September 20, Van Gorkom called to a senior management meeting at which most of Trans Union's directors objected to the deal and at which Romans objected both to the share price and to Pritzker's right of option. After the management meeting Van Gorkom called a special board meeting without providing notice of the purpose. During this meeting Van Gorkom gave a 20-minute oral presentation of the deal with the intention that Trans Union would effectively merge into a new subsidiary that would be fully owned by Pritzker after all of the Trans Union outstanding shares had been sold to Pritzker. No copies of the merger agreement (or any other background information about the merger) were handed out. At this meeting Romans argued that \$55 per share was a rough baseline for the feasibility of a possible leveraged buy-out, but that the price could not be considered indicative of a fair price for the stock or as a valuation of the company. After two hours the meeting was adjourned. The board voted in favor of the merger agreement.

The merger agreement, which neither Van Gorkom nor any other member of the Trans Union board had read, was signed by Van Gorkom the same night. The deal was made public on September 22 and was followed by a wave of resignation threats from key officers of Trans Union. Van Gorkom managed to stop this wave by negotiating an amendment of the contract, allowing Trans Union to solicit other bids during a 90-days window through its investment banker, Salomon Brothers. The amendments were approved by the board on October 8.

Two offers came in. The first one, a competing bid from General Electric Credit, could not be completed within the 90-days window and therefore finally fell through. The second one, a leverage buy-out proposal submitted by officers of Trans Union (not Van Gorkom though) with the financial support of private equity firm Kohlberg Kravis Roberts & Co⁸⁵ also fell through after Van Gorkom managed to convince one of the Trans Union officers that the deal was not "firm", since KKR was dependent on outside financing.

⁸⁵ Hereinafter *KKR*.

3.2.3.4.2.3 The Suit and Trial

On December 19, after the buy-out had been consummated, a class action suit was filed on behalf of more than 10,000 shareholders against Trans Union, its directors and Pritzker, seeking rescission of the cash-out merger of Trans Union and an alternate relief in form of damages. The court chose not to enjoin the merger and a shareholder meeting took place on February 10, 1981. At this meeting a substantial majority of the shareholders, many voting based on the boards proxy, voted for the merger at this meeting.

The case was later tried in the Delaware Court of Chancery and led to a judgment for the directors on July 6, 1982. The court held that the business judgment rule did protect the board's decision to approve the merger and that the shareholders had been fairly informed by the board before voting on the merger. The shareholders appealed against the court's judgment and the case finally got tried in the Delaware Supreme Court, where Van Gorkom and the board of directors were lambasted for their behavior. There were several reasons for why the court considered that the directors should be liable for gross negligence. Two of the reasons were;

(1) that none of the board members had questioned the actual fairness of the proposed share price of \$55 or asked Romans any questions regarding the calculations of the price determination;

(2) because the court did not buy the argument about the claimed 90-day "market test" to ensure fairness of the deal. The Supreme Court held that "[t]here is no evidence: (a) that the Merger Agreement was effectively amended to give the Board freedom to put Trans Union up for auction sale to the highest bidder; or (b) that a public auction was in fact permitted to occur. The minutes of the Board meeting make no reference to any of this. Indeed, the record compels the conclusion that the directors had no rational basis for expecting that a market test was attainable, given the terms of the Agreement as executed during the evening of September 20"⁸⁶.

In a footnote the court also said: "[w]e do not suggest that a board must read in haec verba every contract or legal document which it approves, but if it is to successfully absolve itself from charges of the type made here, there must be some credible contemporary evidence demonstrating that the directors knew what they were doing, and ensured that their purported action was given effect. That is the consistent failure which cast this Board upon its unredeemable course"^{87 88}.

⁸⁶ *Smith v. Van Gorkom*, *supra* note 4.

⁸⁷ *Id.*

⁸⁸ See *Appendix* for an extract of the Delaware Supreme Court Opinion.

The Delaware Supreme Court finally remanded the case to the Court of Chancery with instructions to determine a fair market value of the shares. Once this was done the plaintiffs were to receive damages to the extent that the fair market value exceeded \$55 per share. However, this determination was never made. Instead the claim was settled for \$23.5 million (of which \$10 million was paid from liability insurance taken out by the directors, and the remaining \$13.5 million was paid by Pritzker, on a condition that the directors would pay ten percent of that amount to charity).

3.2.3.4.2.4 Aftermath

As mentioned above, the *Trans Union* case is interesting as it is one of only a few cases where directors have been held liable for a rational business decision (*i.e.* the directors lost their protection of the business judgment rule) in relation to which there were no allegations of bad faith or self-dealing⁸⁹. In their decision, the court made clear that not being informed was a breach of the duty of care and that procedural due care was required in becoming informed. The decision in the *Trans Union* case both flabbergasted and disturbed corporate America and had a great impact on the potential effect of serving on corporate boards due to directors' heightened exposure to liability for breaches of the duty of care. The decision also was one of the reasons for the increased premiums for directors and officers and as a reaction to the decision, many legislatures today have also enacted exculpation provisions⁹⁰ that may limit and sometimes even fully eliminate the liability for directors' breaches of the duty of care.⁹¹ The aftermath of *Smith v. Van Gorkom* will be discussed and analyzed further below, see *Chapter 3.2.5 Exculpation Statutes* and *Chapter 6 Reconstruing the Business Judgment Rule*.

3.2.3.5 Failure When Executing Oversight Functions

In addition to their decision-making function directors also have a broad oversight function. Especially in public corporations, directors have a duty to monitor management (to which the day-to-day business is delegated). To be able to carry out their monitoring duty, directors are presumed to have access to all necessary corporate information.⁹² Directors have to inquire into managers' loyalty and competence in order to carry out their monitoring duty. When

⁸⁹ It should be noted that it has been discussed whether or not the case actually has got some self-dealing overtones. This is primarily based on the fact that the merger would allow Van Gorkom, who at the time was reaching retirement age, to realize \$1 500 000 increase of his shareholding. See Palmiter, A. R., *supra* note 6, at 212.

⁹⁰ See for example MBCA §2.02(b)(4) and Del GCL §102(b).

⁹¹ See Shu-Acquaye, F., *supra* note 82, at 36-37, and Sharfman, B. S., Being Informed Does Matter: Fine Tuning Gross Negligence Twenty Plus Years After Van Gorkom, 62 Bus. Law. 135 (2006) at 136-137.

⁹² It is up to the corporation to bear the burden to permit its directors access to information related to the directorial role. See *Kortum v. Webasto Sunroofs Inc.*, 769 A.2d 113 (Del. Ch. 2000).

examining oversight failures the first thing to check is whether the directors have been inattentive to mismanagement or to management abuse.

(1) *Inattention to mismanagement*: Courts have had an aversion towards imposing liability for directors who have been inattentive to mismanagement. For example, in *Barnes v. Andrews*⁹³ a director, whose “only attention to the affairs of the company consisted of talks with the president [who was a friend of the director] as they met from time to time”, was sued after the business failed because of the president’s poor business judgment. The court concluded that they could not impose liability on the director for the failure of the business, even though he technically had breached the duty of care, since it would have been impossible to second-guess if the director (in any way) would have been able to prevent the failure of the business. Only in a few cases have directors been held liable for inattention to mismanagement. One example is *Hoye v. Meek*⁹⁴, in which the court concluded that a bank director had violated his duty of care under Oklahoma law⁹⁵ by not attending board meetings and by not monitoring risky investment decisions of his son (who held a management role at the bank).

(2) *Inattention to management abuse*: In cases where directors have failed to supervise management abuse⁹⁶ courts have been more willing to impose liability. Whether or not a court will impose liability depends on whether the director knew (or should have known) of the management abuse. One example is *Francis v. United Jersey Bank*⁹⁷. In this case Lillian Pritchard, the widow of the founder of Pritchard & Baird, became a director of the closely held reinsurance company. Mrs. Pritchard turned out to be inactive and knew virtually nothing about the business. Additionally she never read the firm’s annual financial statements, which revealed that her sons were taking client funds in the guise of *shareholder loans*. The widow had failed in becoming informed and in making the necessary inquiries and she was therefore held liable for the \$10.3 million siphoned from company funds by her two sons. Thus, according to *Francis v. United Jersey Bank*, a director is not allowed to be a “dummy” on the board. All of the corporation’s directors have a duty both to attend meetings on a regular basis and to keep track of what is happening in the corporation (including the corporation’s

⁹³ *Barnes v. Andrews*, 298 F. 614 (S.D.N.Y. 1924).

⁹⁴ *Hoye v. Meek*, 795 F.2d 893 (10th Cir. 1986).

⁹⁵ An “ordinarily prudent director” standard.

⁹⁶ E.g. defalcations and deceit.

⁹⁷ *Francis v. United Jersey Bank*, 432 A.2d 814 (N.J. 1981).

financial status). By not fulfilling this duty a director might breach his fiduciary duties and therefore be held liable for the breach.⁹⁸

3.2.4 Remedies for Breaching the Duty of Care

3.2.4.1 Introduction

If the challenger manages to overcome the business judgment presumption⁹⁹ all directors who have participated in the decision-making are liable for a breach of their duty of care. Essentially, courts have two types of remedy; they can either impose personal liability or enjoin the board action.¹⁰⁰

3.2.4.2 To Impose Personal Liability or...

All directors who participate in an action which breaches the duty of care become jointly and severally liable for all damages the action proximately cause the corporation. According to the *MBCA* §8.24(d); “[a] director who is present at a meeting of the board of directors or a committee of the board of directors when corporate action is taken is deemed to have assented to the action taken unless: (1) he objects at the beginning of the meeting [...]; (2) his dissent or abstention from the action taken is entered in the minutes of the meeting; or (3) he delivers written notice of his dissent or abstention to the presiding officer of the meeting before its adjournment or to the corporation immediately after adjournment of the meeting.” (The third option is only possible if the director did not vote in favor of the action.)

It should be noted that some courts do not find it sufficient that a challenger merely proves a breach of the duty of care. These courts additionally require the challenger to prove that there is causality between the breach and the damage caused to the corporation. For example *MBCA* §8.31(b)(1) states that: “[t]he party seeking to hold the director liable [...] for money damages, shall also have the burden of establishing that [...] the harm suffered was proximately caused by the director’s challenged conduct”. However, it should be noted that Delaware courts have chosen a wholly different path in *Cede & Co. v. Technicolor Inc.*¹⁰¹. The court did not make

⁹⁸ Gevurtz, F. A., *supra* note 24, at 274-278 and The New York Times, *Director Held Liable in Suit*, July 2, 1981. (Available at <http://query.nytimes.com/gst/fullpage.html?res=9A04E7DF1E38F931A35754C0A967948260>).

⁹⁹ By proving either; (1) fraud, illegality, or a conflict of interest; (2) a lack of a rational business purpose or; (3) gross negligence in discharging duties to supervise and to become informed. See *Chapter 3.2.3 Overcoming the Business Judgment Presumption*.

¹⁰⁰ Palmiter, A. R., *supra* note 6, at 216-217.

¹⁰¹ *Cede & Co. v. Technicolor Inc.*, 634 A.2d 345 (Del. 1993). It should be noted that this Delaware Supreme Court opinion, which is one of many in the lengthy *Cede & Co. v. Technicolor, Inc.* (a.k.a., *Cinerama, Inc. v. Technicolor, Inc.*) litigation, has been heavenly criticized. See for example: Bainbridge, S. M. on

causality an element of the plaintiff's case. Instead the burden was shifted to the careless defendants to prove the *entire fairness* of the challenged transaction.

3.2.4.3 ...to Enjoin Board Action

Since flawed board actions and decisions are not protected by the business judgment rule, courts also have a possibility of either enjoining or rescinding such actions and decisions.¹⁰²

3.2.5 Exculpation Statutes

The *Trans Union* case prompted an outcry from BODs of public companies and a subsequent effect of the case was a growing conviction that it had become more risky being a corporate director (there were even apprehensions that qualified individuals in fear of personal liability actually would (or at least could) decline to serve on corporate boards entirely) and therefore the premiums for directors' and officers' insurance increased sharply during the 1980s. Eventually it also led to the adoption by the Delaware legislature of a statutory provision¹⁰³ that permits Delaware companies (with an approval of the shareholders) to adopt charter amendments that exculpate directors from personal liability for breaches of the duty of care.¹⁰⁴ Almost all states followed Delaware's lead and enacted exculpation statutes that authorized charter amendments shielding directors from personal liability for breaching their duty of care.¹⁰⁵

A Delaware company's exculpation provision may prescribe¹⁰⁶ elimination or limitation of the personal liability for a director's breach of a fiduciary duty, but cannot remove liability for:

- (1) any breach of the director's duty of loyalty;
- (2) acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;
- (3) approval of unlawful distribution or;

Businessassociationsblog.com on Law and Business, Thursday, March 11 2004, *Cinerama v. Technicolor: The Anticlimax*. (Available at

http://www.businessassociationsblog.com/lawandbusiness/comments/cinerama_v_technicolor_the_anticlimax/).

¹⁰² Palmiter, A. R., *supra* note 6, at 217.

¹⁰³ Del. GCL §102(b)(7).

¹⁰⁴ According to *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 777 (Del. Ch. 2004) "One of the primary purposes of §102(b)(7) is to encourage directors to undertake risky, but potentially value-maximizing, business strategies, so long as they do so in good faith".

¹⁰⁵ See for example MBCA §2.02(b)(4).

¹⁰⁶ See DEL GCL §102(b)(7) and §174.

(4) for any transaction from which the director derives an improper personal benefit.

This can be compared to the exculpation provision provided in the MBCA¹⁰⁷, where the liability of a director, to the corporation or its shareholders, may be eliminated or limited for money damages, with an exception for the liability for:

(1) financial benefits received by the director to which he is not entitled;

(2) intentional inflictions of harm on the corporation or the shareholders;

(3) approval of illegal distribution and;

(4) intentional violation of criminal law.

However, exculpation statutes are the fountainhead of many problematic issues. Should directors really be able to escape personal liability when they breach their fiduciary duties? Exculpation statutes in public corporations are approved by the shareholders, often through proxy voting – but when most shareholders hardly can be considered well-informed (and therefore frequently, in proxy voting situations, vote in favor of what the BOD has proposed) are they really best placed to consider if an exculpation statute should be approved? In 1989 Michael Bradley and Cindy Schiapani published a study¹⁰⁸ showing; (a) that the *Trans Union case* had no statistical effect on Delaware corporation stock prices, but that in the wake of the *Trans Union case* both directors and officers premiums increased drastically and;¹⁰⁹ (b) that Delaware's adoption of *Del. GCL §102(b)(7)* decreased the relative values of Delaware corporations.¹¹⁰

Exculpation statutes will also be discussed and analyzed in *Chapter 6 Reconstruing the Business Judgment Rule*.

¹⁰⁷ See MBCA §2.02(b)(4) and §8.33.

¹⁰⁸ Bradley, M., Schiapani, C., The Relevance of the Duty of Care Standard in Corporate Governance, 75 Iowa L. Rev. 1 (1989).

¹⁰⁹ *Id.* at 50-51.

¹¹⁰ *Id.* at 60-61.

4 THE BUSINESS JUDGMENT RULE AND EXECUTIVE COMPENSATION

4.1 Introduction

This chapter will briefly explain some fundamental facts about executive compensation. This chapter is mainly an introduction to the following chapter, *Chapter 5 Modern Developments of the Business Judgment Rule*, in which the *In re Walt Disney Co. Derivative Litigation*¹¹¹ will be examined. Similar to the *Trans Union case*, the *Disney case* (in which executive compensation was an important component) has had a great impact on corporate America.

4.2 The Duty of Loyalty and Executive Compensation

As mentioned above, see *Chapter 2.1 Introduction*, the duty of loyalty addresses conflicts of interest of corporate decision makers' and situations of corporate self-dealing. According to this fiduciary duty corporate decision makers have to put the corporation's interest ahead of their own. If a corporate fiduciary, for personal gain, diverts corporate assets, opportunities or information, the duty of loyalty will be breached.¹¹²

Executive compensation is a necessary form of self-dealing in the corporation and just like other forms of corporate self-dealing diversion might occur if the corporate fiduciary breaches his fiduciary duty. In case of executive compensation a breach occurs if the fiduciary's compensation exceeds the fair value of his executive services. However, in one respect executive compensation is different from other forms of corporate self-dealing – if the compensation is approved by *disinterested and independent directors*¹¹³ it will be protected by the business judgment rule.¹¹⁴

¹¹¹ Hereinafter *the Disney case*.

¹¹² Palmiter, A. R., *supra* note 6, at 192.

¹¹³ Often this is done by a *compensation committee* of outside directors. See for example MBCA §8.25(d).

¹¹⁴ Palmiter, A. R., *supra* note 6, at 249 and 253.

4.3 Executive Compensation and the Business Judgment Rule

If an executive compensation gets protected by the business judgment rule, the burden of proof is on the plaintiff shareholder to show either that the board was *grossly uninformed* or that the compensation was a *waste of corporate assets* (*i.e.* that it had no relation to the value of the services given – making it a gift).

The system with approval by disinterested and independent directors has been illustrated in *Rogers v. Hill*¹¹⁵ relating to the compensation paid to the president and five vice presidents of American Tobacco during the Depression. In 1912, the shareholders of American Tobacco adopted a bylaw implying that the executives would receive annual bonuses based on a percentage of the corporation's net profits above a stated base (*i.e.* if the company would make money so would the executives). When the Depression hit America people began to smoke more and hence it was a good time for the tobacco industry and its executives. American Tobacco's president's annual bonus under the bylaw had increased to an astonishing \$842,000 by 1930. The same year the annual bonuses of each vice president had increased to \$409,000. Some of American Tobacco's shareholders challenged the executive compensations, claiming that they were excessive. The Supreme Court refused to overrule the given compensation, alleging that the bylaws had been unanimously approved by the shareholders. Furthermore, the court held that the only way the bonuses could have been challenged was if the shareholders could prove them to be a *complete waste of corporate assets*.

Even though the compensation of corporate managers has spiraled upwards at an incredible pace lately, courts have held on to this way of reasoning.

¹¹⁵ *Rogers v. Hill*, 289 U.S. 582 (1933).

5 MODERN DEVELOPMENTS OF THE BUSINESS JUDGMENT RULE

5.1 The Disney Case

5.1.1 Introduction

The *Disney case* is one of the most interesting litigations in recent time concerning the developments of the business judgment rule.¹¹⁶ As noted earlier, Delaware courts have traditionally, and legitimately, been reluctant to try cases that second-guess corporate decision-making, hinging on the business judgment maxim that directors are more qualified to make business decisions than judges.¹¹⁷ In recent time (perhaps as a response to the well publicized corporate scandals that have taken place during the last years) the courts of Delaware and elsewhere, have become more willing both to review corporate action and decision-making and to police the behavior of corporate managers – particularly when the managers have benefited at the expense of the company.¹¹⁸ When analyzing the *Disney case*, you have to bear in mind that this litigation began before scandals such as Enron, WorldCom, Tyco International and Adelphia took place, and that the outcome of the *Disney litigation* is based on the prevailing conditions of that time.

5.1.2 Background

In 1994, after the death of Frank Wells (the then COO and President of the Walt Disney Company¹¹⁹), Disney's CEO and Chairman of the Board Michael Eisner began to look for a second-in-command (who would serve as Eisner's heir). Eisner ended up asking Michael Ovitz, the founder and majority owner of Creative Artists Agency¹²⁰, if he was interested in

¹¹⁶ Both concerning the good faith-standard and executive compensation.

¹¹⁷ See *International Ins. Co. v. Johns*, *supra* note 40, and Chapter 3.2.2 *The Business Judgment Rule*.

¹¹⁸ Udell, R. J., In Re: The Walt Disney Company Derivative Litigation: Refining The Limits of The Business Judgment Rule Under Delaware Law (White and Williams LLP Publications), September, 2003. (Available at <http://www.whiteandwilliams.com/CM/NewsAlerts/NewsAlerts312.asp>).

¹¹⁹ Hereinafter *Disney*.

¹²⁰ Hereinafter *CAA*.

filling the vacancy. Ovitz who at the time was one of Hollywood's most powerful persons (receiving approximately \$20 million a year in remuneration from his extraordinarily successful talent agency) had been a close friend of Eisner's for almost 25 years.

In the beginning of August, 1995, Eisner and Ovitz reached an agreement for Ovitz to become the new President of Disney and on August 14, Eisner and Ovitz signed a letter agreement outlining the basic terms of Ovitz's employment, stating that the agreement, which ultimately would be embodied in a formal contract, was subject to approval by Disney's compensation committee and BOD. On the same day, Ovitz's hiring was made public in a press release. The public's reaction was positive, making Disney's stock price rise 4.4% in a single day, increasing Disney's market capitalization by over \$1 billion. Disney's BOD appointed Ovitz president effective on October 1, 1995. Ovitz was also elected to Disney's BOD.

It was up to Disney's compensation committee to approve Ovitz's compensation package. Ovitz (who would give up his 55% ownership in CAA to join Disney) demanded to have an extensive termination provision – a so called “*downside protection*” – included in his five-year employment contract. Ovitz's final severance package entailed that if Disney would terminate his contract, other than for *gross negligence or malfeasance*, he would receive the following; (a) his base salary for the remainder of the contract; (b) three-quarters of the maximum annual bonus, which he might have received if he would have stayed with Disney for the remainder of the contract; (c) immediate vesting of all stock options to which he would have been entitled for the five years of his contract and; (d) \$10 million, a substitute for the stock options to which he would have been entitled if the contract had been extended for a second five year period. Even though the compensation committee never got to review and approve the final version of Ovitz's severance package, they did approve prior summaries of drafts of the agreement.

Ovitz's tenure as President of Disney began on October 1, 1995. At this time no definitive employment agreement existed. The compensation committee only received a status report of the ongoing negotiations as of October 16, but they never were provided with either a draft of the agreement or any other additional facts. Several drafts of the agreement did however circulate between Ovitz and Eisner before the agreement finally was executed on December 12, 1995 and made retroactively effective to October 1. Neither the BOD nor the compensation committee got to review or approve the final agreement albeit it differed significantly from the summaries of the drafts previously provided to them. It was not until the final agreement that Ovitz got provided with the benefits of a non-fault termination, as long as he did not act with gross negligence or malfeasance – allowing him to receive benefits even in case he acted with negligence that could not be proven to be gross. According to prior drafts of the agreement, which had been summarized to the compensation committee, Ovitz would only get provided with these benefits if his contract was wrongfully terminated by Disney.

Ovitz turned out to be a poor fit with his fellow executives and his working performance could only be described as a disappointment. About a year after Ovitz's appointment, the

terms for the termination of his contract was discussed by the directors of Disney and on December 12, 1996, Ovitz finally got dismissed. Since the Disney directors could not find any plausible cause for the termination within the meaning of the employment agreement (*i.e.* gross negligence or malfeasance could not be proven) Ovitz underwent a non-fault termination. Therefore Ovitz was entitled to the severance package, in accordance with his employment contract, giving him more than \$140 million. Disney's shareholders had not been amused by Ovitz's poor job efforts and they were certainly not amused by the egregious amount of money being paid to get rid of him. Ultimately it led to the inevitable, a derivative lawsuit by some of Disney's shareholders, claiming that Eisner, Ovitz, and the Disney board had violated their fiduciary duties when negotiating the terms of the employment agreement as well as in allowing Ovitz to depart without claiming cause within the meaning of the agreement.

5.1.3 The Suit and Trial

For almost a decade the *Disney case* spawned five published court opinions – three from the Delaware Chancery Court and two from the Delaware Supreme Court.¹²¹ At first the plaintiffs mostly based their claims (that the board had breached their duty of care) on waste arguments. In these claims, the plaintiffs asserted that Ovitz's termination provision in fact entailed waste as the provision lead to a situation where Ovitz would do better losing his job than keeping it (on condition that he did not commit gross negligence or malfeasance). According to the plaintiffs, Disney's board had not considered the possible impact of Ovitz's termination provision when approving it. Furthermore, the plaintiffs claimed that Ovitz's non-fault termination constituted waste by alleging that there *de facto* had existed plausible grounds to claim cause within the meaning of Ovitz's employment agreement (and thereby avoiding to trigger the termination provision). The Court of Chancery rejected all of the plaintiffs' claims on the merits and entered a judgment in favor of the defendant on all counts.

The plaintiffs appealed against the judgment, claiming that both the decision to approve Ovitz's employment agreement and the decision to terminate Ovitz on a non-fault basis were results of various breaches of fiduciary duties by Ovitz and the Disney directors. The Supreme Court of Delaware finally affirmed the dismissal of the plaintiffs' complaint. However, the court did consider the behavior of the board to be slightly questionable and therefore allowed the plaintiffs to re-plead their care and waste claims.

¹²¹ (1) *In re The Walt Disney Company Derivative Litigation*, 731 A.2d 342 (Del. Ch. 1998) – where complaint got dismissed; (2) *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) – affirming the dismissal, but holding that the plaintiffs should receive leave to amend; (3) *In re The Walt Disney Company Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003) – denying motion to dismiss amended complaint. The final verdict, (5); *In re The Walt Disney Company Derivative Litigation*, 906 A.2d 27 (Del. 2006) was an affirmation of (4) *In re The Walt Disney Company Derivative Litigation* 907 A.2d 693 (Del. Ch. 2005).

This time the plaintiffs exercised their shareholder inspection rights and returned with an amended complaint, focusing more on the good faith-standard and the impact of the friendship between Eisner and Ovitz. According to the plaintiffs the procedural aspects of the meetings leading to Ovitz's appointment were disputable and dubious. At the compensation committee meeting, when the terms of Ovitz's employment were approved, the committee only briefly discussed an incomplete summary of the terms before giving their approval. The committee never reviewed the final employment agreement and they did not receive (or tried to examine) any other information about the possible impact of Ovitz's employment agreement. The plaintiffs claimed that Disney's BOD blindly accepted the recommendation of the committee without requesting any elucidating information. This time the Delaware Chancery Court was more critical against the defendants' performances, painting a picture of directors who consciously and intentionally disregarded their responsibilities. In addition to this the plaintiffs alleged that, since Ovitz began to serve as an officer at Disney prior to the finalization of his employment agreement he owed a duty to negotiate honestly and in good faith to the company (making him unable to take personal advantage at the shareholders' expense). According to the plaintiffs Ovitz had breached this duty. The court commented on Eisner's and Ovitz's twenty-five friendship, claiming that Ovitz should have negotiated with impartial directors (such as the compensation committee) instead of with his old friend. The court also specifically noted that the final version of the employment agreement differed considerably from the drafts of the agreement (which were provided to the directors). This made it impossible for the court to dismiss the claims against Ovitz on his activity since the facts as alleged suggested that the subsequent changes of the drafts were the product of Ovitz engaging in a self-interested transaction by negotiating with his friend. It was not a matter of arms' length bargaining.¹²²

However, the Delaware Chancery Court finally found that the conduct of both Ovitz and the directors of Disney did not entail them to lose the protections of the business judgment presumption. The failure to analyze the full consequences of Ovitz's severance package constituted negligence, but it could not be considered *gross*. On appeal the Supreme Court affirmed this decision in 2006.¹²³

¹²² Furthermore the court made a specific note of the fact that Ovitz was a member of the board at the time of his termination. According to the courts holding in *Texlon v. Meyerson*, 802 A.2d 257, 265 (2002), a directors decisions on his or her own compensation might entail a breach of the duty of loyalty, leaving the director without the protection of the business judgment rule, consequently resulting in that, when challenged, the receipt of self-approved benefits becomes subject to a showing of fairness to the corporation.

¹²³ *Supra* note 121.

5.1.4 Conclusion and Aftermath

Even though neither Ovitz nor any of the Disney directors were convicted, the mere fact that the case was tried shocked corporate America. The case may serve as a warning sign for corporate decision makers that Delaware courts, and possibly also courts of other states, may have become less willing to let directors hide behind the business judgment rule when they fail to act in good faith when carrying out their fiduciary duties.¹²⁴

5.2 The Substance of Directors' Business Decisions and a New Good Faith Standard?

5.2.1 The Substance of Directors' Business Decisions

Because of the business judgment rule, courts will generally not review the substance of corporate decision makers' business decisions. This is not based on a belief that managers always do the right thing or take the right decision, but rather on the thought that investors' wealth would be lower if managers' decisions were routinely subjected to strict judicial review.¹²⁵ Thus, corporate decision makers will be willing to take the corporate risks investors want them to, since this risk-taking is protected from shareholders that otherwise might impose liability. This has become a widespread belief and today, despite recent scandals and negative publicity surrounding the conduct of corporate directors, few participants in the debate are calling for significant changes to how the rule regards actions taken by corporate managers. The company, and thus its shareholders, is more likely to make money when the corporation's directors know that they can take business risks without the fear of becoming subject to legal actions imposing liability. However, this does not mean that corporate managers never should be reviewed. Wealth maximization will be reached when business decisions are reviewed by investors, analysts, stockholders and business partners – but not by the courts.¹²⁶ This was mentioned by Chancellor Chandler, the Delaware Court of Chancery's

¹²⁴ See for example *In re The Walt Disney Company Derivative Litigation: Implications for Directors and Executives* (Sherman & Stearling Client Publication), June 5, 2003. (Available at http://www.shearman.com/files/Publication/1b93d9f8-5486-4edb-9a8d-e7b2273fd934/Presentation/PublicationAttachment/369cb9f4-902c-4371-84d8-07fad12703f5/COMP_060503.pdf) and Udell, R. J, *supra* note 118.

¹²⁵ See for example *In Re Caremark Int'l Inc. Derivative Litigation*, 698 A.2d 959, 967 (Del. Ch. 1996): “To employ a different rule—one that permitted an ‘objective’ evaluation of the decision—would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run be injurious to investor interests”.

¹²⁶ Rosenberg, D., Galactic Stupidity and the Business Judgment Rule, 32 J. Corp. L. 301 (2006), at 302.

in the *Disney* decisions of August 2005¹²⁷: “The redress for failures that arise from faithful management must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court. Should the Court apportion liability based on the ultimate outcome of decisions taken in good faith by faithful directors or officers, those decision-makers would necessarily take decisions that minimize risk, not maximize value. The entire advantage of the risk-taking, innovative, wealth-creating engine that is the Delaware corporation would cease to exist, with disastrous results for shareholders and society alike”. Hence, except for when it actually allows review, the business judgment rule could be conceived as “a policy of judicial non-review”¹²⁸. The problem is how to know when the rule allows review (i.e. “[t]he problem is to identify the circumstances in which intervention is necessary. Put another way, when do accountability concerns trump preservation of the board's authority?”¹²⁹). A fundamental thought in the debate has been that reviews of the substance of corporate managers decision making is not allowed by the business judgment rule at all. However, Delaware courts have begun to show an increasing willingness to do so, especially when the actions seem to have exceeded good faith.¹³⁰ In cases where the plaintiffs allege bad faith, but the facts present neither evidence of disloyalty nor a knowing breach of duty, courts will review the substance of the decision in order to determine whether or not the directors have complied with all of their fiduciary obligations and hence, whether the plaintiffs have successfully rebutted the presumptions of the business judgment rule.¹³¹

However, *substantive due care* reviews of this kind are most likely to be done by the courts when reviewing cases of self-dealing (i.e. breaches of the duty of loyalty). When the duty of care is under review, courts have been less willing to do the same thing. Business decisions that turn out to be disastrous will not be reviewed by courts as long as either the decision was made in good faith or the process leading to the decision was rational.¹³² In one of the court opinions spawned by the *Disney* case, Chancellor Chandler wrote that Delaware courts will not “hold fiduciaries liable for a failure to comply with the aspirational ideal of best practice”¹³³. According to Rosenberg this means that “courts will not review the substantive wisdom of decisions made by corporate directors; put another way, courts will not engage in substantive due care analysis”¹³⁴.

¹²⁷ *Supra* note 121.

¹²⁸ Johnson, L., The Modest Business Judgment Rule, 55 Bus. Law. 625, 631 (2000), at 631.

¹²⁹ Bainbridge, S. M., The Business Judgment Rule as Abstention Doctrine, 57 Vand. L. Rev. 83 (2004), at 127.

¹³⁰ See Chapter 5.2.2 *A New Good Faith Standard?*

¹³¹ Rosenberg, D., *supra* note 126, at 304-305.

¹³² See Chapter 3.2.2 *The Business Judgment Rule*.

¹³³ *In re The Walt Disney Company Derivative Litigation* 907 A.2d 693 (Del. Ch. 2005).

¹³⁴ Rosenberg, D., *supra* note 126, at 304-305.

5.2.2 (The Disney Case and) the Arising of a New Good Faith Standard

In 2003, the Delaware Court of Chancery heard the amended complaint¹³⁵ of the Disney plaintiffs. This time the court took a closer look at the directors' actions and inactions when approving Ovitz's no-fault termination agreement. The court ultimately held one of the cores of the case to be the question of good faith. The plaintiffs alleged that the directors' actions and inactions were failures going beyond negligence (maybe even beyond gross negligence) by claiming that "*the defendant directors consciously and intentionally disregarded their responsibilities, adopting a 'we don't care about the risks' attitude concerning a material corporate decision*"¹³⁶. The plaintiffs meant that the directors must have known that they took decisions on an inadequate basis, and that they simply did not care about the harm caused to the company and its shareholders. The court condemned such a directorial behavior and said that if the allegations were true, the defendant directors likely had fallen outside the protection of the business judgment presumption by breaching their duty to "*act honestly and in good faith in the corporation's best interests*".¹³⁷

This way of reasoning indicated that the court had a new way of understanding the good faith-standard which lead to a debate with deviating conclusions. According to one commentator the decision revealed "*a clearly emerging third, and [from the duty of care and the duty of loyalty] separate, duty: that of good faith*"¹³⁸. This rationale was mainly based on the fact that the court had not categorized the directorial misconduct as a pure breach of the duty of care,¹³⁹ and that it therefore had to be a question of good faith. The theory had one big problem though; it did not explain what kind of behavior that could constitute a breach of the duty of good faith without breaching the duty of care or loyalty at the same time.¹⁴⁰

Another commentator did not agree that the duty of good faith was a separate entity alleging that good faith never could exist as a solitary entity. It would never be able to define itself without the presence of other duties. Instead, the duty of good faith is omnipresent, encompassing all the obligations of corporate officers and leading to a situation where "*a knowing breach of the duties of care or loyalty [...] is a breach of the duty of good faith*"¹⁴¹. Or in other words: "*[t]here is no line connecting good faith and fiduciary duties. Rather, good faith is a circle around which all duties, corporate or contractual, are surrounded [...]*

¹³⁵ *Supra* note 121.

¹³⁶ *In re The Walt Disney Co. Derivative Litigation*, 825 A.2d 275 (Del. Ch. 2003).

¹³⁷ *Id.*

¹³⁸ Sale, H. A., Delaware's Good Faith, 89 Cornell L. Rev. 456, 482 (2004), at 482.

¹³⁹ If it would have been a pure breach of the duty of care the court would have allowed exculpation under Del. GCL §102(b)(7), which the court did not do in this case.

¹⁴⁰ Rosenberg, D., *supra* note 126, at 307.

¹⁴¹ *Id.* at 307.

[g]ood faith is merely a way of interpreting whether the parties adhered to the duties imposed upon them by the corporate charter or by contractual agreement”¹⁴².

A third commentator¹⁴³ alleged that the duty of good faith should be understood as a rhetorical device rather than as a substantive standard. According to this commentator good faith had not been separated from either the duty of care or the duty of loyalty. Instead, good faith should be considered to alternate between the two without encompassing either. The good faith standard allows issues to be raised under both the duty of care and the duty of loyalty, blending the issues together and thereby identifying a basis for liability under the duty of good faith.¹⁴⁴ However, good faith had not and would most likely never develop into a “distinct doctrine of subrules and multipart tests”¹⁴⁵ like the duties of care and loyalty. The duty of good faith has emerged in times of crises and scandals – the fraud and failures of companies like Enron, WorldCom, Tyco International and Adelphia and insider trading by celebrities like Martha Stewart. After the Enron scandal, the laxity of the states (especially Delaware) got heavily debated and the *good faith thaumatrope* might be seen as a response in rhetoric to this environment of crisis and debate.¹⁴⁶ “In periods of crisis and scandal, the judiciary employs rhetorical devices to increase the accountability of boards in order to make the judiciary appear responsive and thus alleviate the set of pressures then threatening them, only to return, once the pressure recedes, to a position of board deference”¹⁴⁷.

Even if these commentators have different ways of describing the “new” good faith standard they seem to agree on that good faith has reemerged as an effect of recent year’s corporate scandals and crises in American corporate governance.

¹⁴² Rosenberg, D., Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach, 29 Del. J. Corp. L. 491 (2004), at 513.

¹⁴³ Griffith, S. J., *supra* note 55.

¹⁴⁴ *Id.* at 6-7 and 34-43. Griffith calls this “*thaumatrope analytics*”, referring to an optical toy involving a disc with a string attached to its edges (enabling it to spin) and with two different images on each side of the disc – for example, a bird on one side and a cage on the other. When the disc is spinning, the images of the bird and the cage will blend together into a composite third image - the bird in the cage. “Good faith, I argue, is simply the application of the thaumatrope to the duties of care and loyalty. Spinning the two together, the composite image--of a poor decisionmaking process mixed with hints of conflicting interest--may trigger liability under something the judiciary now calls “good faith””.

¹⁴⁵ *Id.* at 6.

¹⁴⁶ *Id.* at 7-8.

¹⁴⁷ *Id.* at 2.

6 RECONSTRUCTING THE BUSINESS JUDGMENT RULE

It is not difficult to notice that the trend for a long period of time has been to increase the protection of, and thus benefiting, corporate decision makers and their interests to the disadvantage of shareholders and the company as a whole. At first sight this development might not seem strange in itself considering that good-faith corporate decision making to some extent have to be protected from judicial second-guessing (hence protecting corporate decision makers from liability).¹⁴⁸ However, it is questionable if the prevalent interpretation of the rule is justified and in a larger perspective, if the business judgment rule is construed in a proper way – when today courts chose to construe the business judgment rule in a way that favors corporate decision makers (whom in addition to the protection from the business judgment rule also are given an extensive statutory protection). Therefore it seems like the business judgment rule might even have become superfluous.

Today, courts interpret the business judgment rule in a way where the protection of corporate decision makers is the most important consideration, when instead the courts should aim at protecting the corporation as a whole (not just the corporate managers). Courts should construe the rule so that it could prevent litigation and thus protect the corporation from the expense of a suit¹⁴⁹ that challenges decisions within the purview of the BOD. However, courts tend not to treat the rule this way. Instead, which the Delaware Supreme Court described in *Aronson v. Lewis*¹⁵⁰, the rule tends to be characterized as an evidentiary presumption in favor of directors.

It is questionable if the justification grounds for the rule are satisfying. The statement that directors are better business experts than judges might not be true since courts, when they second-guess a corporate decision, routinely uses professional business expertise¹⁵¹. With this external help of business experts, courts should be able to apply the same standards of liability to corporate decision makers as they do to other decision makers in other fields for which the court require professional expertise. This should especially be the case at times when

¹⁴⁸ According to the ALI Principles the main justification for the rule is the need “to protect directors and officers from the risks inherent in hindsight reviews of their unsuccessful decisions, and to avoid the risk of stifling innovation and venturesome business activity”. See ALI Principles §4.01 comment d.

¹⁴⁹ Both in form of dissipation of resources and harm of the reputation that could arise in a discovery process.

¹⁵⁰ *Aronson v. Lewis*, *supra* note 29.

¹⁵¹ Often in the form of expert witnesses.

corporate decision makers have to rely on expert opinions themselves.¹⁵² In these situations the decision makers concede that they, by themselves, do not have the specific expertise needed to make the relevant decisions. This should consequently lead to a situation where there are no arguments for why a court should be considered less qualified than the corporate decision makers to assess the quality of decisions on specific matters. Moreover, in a jurisdiction like Delaware, where judges are recognized for their special business and varied commercial expertise, the argument that judges are not as qualified as directors to make qualified business decisions does not seem applicable at all. Today, Delaware is not the only state that distinguishes itself by having judges with business expertise. During the last ten years the creation of specialized business courts in the United States has expanded greatly.¹⁵³

But even if judges today often must be considered to be as qualified as corporate decision makers a problem still exists. The judicial re-examination of the business decision is done with the favor of hindsight. When conducting their tasks, BODs and corporate managers will have to make decisions that involve the balancing of risks and benefits for the corporation. Occasionally one of these decisions will, in all probability, turn out to be detrimental to the corporation. I agree that it is impossible to foresee the consequences of *some* business decisions and that it would be unfavorable to re-examine *these* decisions with the favor of hindsight. However, I do argue that the judicial re-examination of for example; (1) decisions constituting apparent business folly (such as in *Schlensky v. Wrigley*¹⁵⁴) and; (2) decisions which a corporate manager *should be able to understand* to be detrimental to the corporation (such as Michael Ovitz's non-fault termination provisions in the *Disney case*),¹⁵⁵ should not be too lenient because of the favor of hindsight (since the corporate decision makers simply should be able to foresee the consequences of their decisions in these situations) and that courts should try to be less willing to forgive the decision makers in these situations. One way to do this might be to heighten the fiduciary duty of care standard from an "ordinarily prudent person"-standard to something more "demanding". Would it be strange if the requirements for a qualified corporate decision maker would be higher than those for an "ordinary prudent person"? Courts should cease to be indulgent towards these forms of directorial behavior and they should not let incompetent and foolish corporate decision makers hide behind business folly or insurmountable standards (such as the waste or negligence standards). The main problem with this way of reasoning is of course how to determine why a specific business decision should be graded in a certain way – a problem to which I have no answer. But considering that courts do similar determinations today – for example they determine whether a business judgment has crossed the line from *negligence* to *gross negligence* – I cannot understand why they should not be able to classify business decisions.

¹⁵² This is allowed in Delaware under Del. GCL §141(e).

¹⁵³ For more information about the growing numbers of specialized business courts see: Bach, M. L., Applebaum, L., A History of the Creation and Jurisdiction of Business Courts in the Last Decade, 60 Bus. Law. 147 (2004).

¹⁵⁴ *Supra* note 71.

¹⁵⁵ I consider Ovitz's employment agreement in the *Disney case* – an agreement that led to a situation where Ovitz benefited more from getting fired than from performing his duties – to be an example of this.

The business judgment rule has always had a credibility problem in that it is not statutory¹⁵⁶ and today, as mentioned just above, the question is whether or not the rule simply has become an insurmountable, and maybe even unfounded, barrier for shareholders to claim their rights. Consider the circumstances around Ovitz's hiring and firing in the *Disney Case*. In his opinion, Chancery Chandler considered the conduct of the Disney BOD to fall "*significantly short of the best practices of ideal corporate governance*"¹⁵⁷. However the conduct was not considered to constitute gross negligence and therefore the directors had not breached their fiduciary duty of care. It is not easy to imagine what actually *would* constitute gross negligence.¹⁵⁸ The waste standard has also become an insurmountable barrier for shareholders. In the *Disney case* the plaintiffs claimed waste based on the fact that Ovitz's employment agreement encouraged him to leave Disney. However, the court meant that it was unreasonable that Ovitz intentionally would try to perform his job duties poorly enough to receive the payment to which he was entitled in the termination provisions but good enough to not get terminated within cause of the employment agreement.¹⁵⁹ I understand the court's way of reasoning – of course it seems strange that Ovitz would try to walk a tightrope like this – but at the same time it has to be remembered that we are talking about a \$140 million compensation, not small change.

Of course there are reasons for protecting corporate decision makers. For example both separate companies and the economy as a whole are substantially benefited by corporate innovation and risk-taking. Both innovation and risk-taking are worthy of an extensive protection. The business judgment rule has served this purpose for a long period of time. And there are concerns that the incentive for entrepreneurial action would be lost if the rule was construed in a different way (or if it would be removed). However, new statutory standards should have the ability to eliminate the fear of an eventual loss of directorial innovation that might arise.

Seen in the aftermath of the *Trans Union case*, a great problem that occurs when courts discuss the business judgment rule is the psychological effect that it has on corporate America.

¹⁵⁶ See for example Gevurtz, F. A., *supra* note 24, at 279 – "*A difficulty with the business judgment rule occurs, however, when courts and writers go beyond the general concept of judicial restraint and attempt to inject specific content into the rule. Immediately, a lack of consensus emerges as to exactly what the business judgment rule really is. An example of this difficulty occurred during the drafting of the 1984 revision of the Model Business Corporation Act. The drafters of the 1984 revision initially thought it would be a good idea to include the rule as part of the Act. This process broke down, however, when the drafters could not reach a consensus on a formulation of the rule. As one of the participants explained, "we are saying that there is a business judgment rule, that we know what it is and when it should be applied, but we can't define it."*" (Footnotes omitted).

¹⁵⁷ *In re The Walt Disney Company Derivative Litigation*, No. CIV.A. 15452, 2005 WL 1875804, 2005 Del. Ch. LEXIS 113 (Del. Ch. 2005).

¹⁵⁸ The *Disney case* might be a child of its time though and it is questionable if a Delaware court would reach the same conclusion if the case would be tried today. The main reason for this is the current regulatory and governance landscape – for example the enactment of the Sarbanes-Oxley Act of 2002 and recent year's adoption of "best practices" by public companies.

¹⁵⁹ *In re The Walt Disney Company Derivative Litigation*, No. CIV.A. 15452, 2005 WL 1875804, 2005 Del. Ch. LEXIS 113 (Del. Ch. 2005).

Widespread apprehension (that qualified individuals in fear of personal liability actually would (or at least could) decline to serve on corporate boards entirely) followed. This led many states to start enacting exculpation statutes¹⁶⁰.

Legislators of today have created and/or permitted numerous statutory alternative means of protecting directors from liability for their business decisions. *A first example* is how Delaware, after the *Trans Union* case, amended its Corporations Law to permit corporations to stipulate in their bylaws that directors will not be held liable for damages for breaches of their duty of care, *Del. GCL §102(b)(7)*. Many other states followed and passed similar statutes. *A second example* is how Delaware corporate law nowadays permits corporations to indemnify their officers and directors against liability in civil or criminal actions, *Del. GCL §145(a)-(b)*. If an officer or a director incurs costs in connection with legal actions were the officer or director “*has been successful on the merits or otherwise*” indemnification is mandatory under Delaware law, *Del. GCL §145(c)*¹⁶¹. On top of the protection from liability and indemnification, corporations often insure their officers and directors to fill the gaps of the corporate indemnification, *Del. GCL §145(g)*¹⁶². *A third example* is that many state legislators have adopted procedural rules to deter suits against corporate directors. The statutes, modeled after the MBCA, require that a plaintiff post security for the corporation's expenses and attorneys' fees to be incurred in connection with the suit, unless the plaintiff is a significant shareholder (usually holding over 5% of outstanding shares or \$25,000 worth of the defendant corporation's stock).¹⁶³ It should be noted that these examples arose a long time after the business judgment rule. It seems that the business judgment rule, once the most import way to protect directors from liability for violations of their duty of care, has become superfluous thanks to new statutory protections. The actual risk for liability for corporate managers does no longer correspond to the safety net being offered to them.

Shareholders in general do not want their corporate directors to be overly risk averse and naturally, corporate directors ought to get a proper protection for the risks that the shareholders presume that the directors should take and in cases *Air Line Pilots Ass'n v. UAL Corp*¹⁶⁴ and *Resolution Trust Corp. v. Blasdel*¹⁶⁵ courts have recognized the need of some corporate risk-taking. But today, due to the statutory exculpation provisions mentioned just above, most corporate managers never have to take any actual risks that might make them personally liable. Thus, corporate managers have kept their (constantly growing) benefits despite this waning risk of liability. At the same time, the course of action for the shareholders to impose liability on the managers is getting increasingly intricate. The fact that corporate

¹⁶⁰ See for example Del GCL § 102(b)(7).

¹⁶¹ There is a corresponding statute in the MBCA §8.52 – “*A corporation shall indemnify a director who was wholly successful on the merits or otherwise, in the defense of any proceeding to which he was a party because he was a director of the corporation...*”.

¹⁶² See also MBCA §8.57.

¹⁶³ It should be noted that it is not required to post security in Delaware.

¹⁶⁴ *Air Line Pilots Ass'n v. UAL Corp.*, 717 F. Supp. 575, 582 (N.D. Ill. 1989).

¹⁶⁵ *Resolution n Trust Corp. v. Blasdel*, 930 F.Supp. 417, 423 (D. Ariz. 1994).

managers today can elude their liability for breaches of their fiduciary duties and at the same time are free to claim egregious compensations is a problem. To reconstrue the business judgment rule might be a step in the right direction.

It has been widely discussed whether qualified individuals would be unwilling to serve on boards if their decisions were not protected by the business judgment rule in the way that they are today.¹⁶⁶ If these individuals despite this would be willing to serve on boards, the question is whether or not they would become overly risk averse, leading to an unfavorable situation for investors. It is difficult to find any empirical evidence that supports this concern though. We have seen some examples¹⁶⁷ of when corporate directors have been forced to personally pay damages. But considering that many of these examples have involved criminal wrongdoing, it is difficult to draw a satisfying conclusion.

In the end you have to ask yourself if you consider it to be fair that corporate decision makers are given such an extensive business judgment protection whilst the fiduciary duties that they owe to their companies seems to be getting more lax. Considering the historical delicacy of questions dealing with changes of the business judgment rule, it might be improvident for example to remove the rule overnight. However, a modification of how the rule is construed is desirable...at least in a shareholder perspective.

¹⁶⁶ See for example *Chapter 3.2.3.4.1.4 Aftermath* about the aftermath of the *Trans Union* case.

¹⁶⁷ E.g. Enron and WorldCom.

Appendix

Extract from the Delaware Supreme Court opinion in the *Trans Union* case.

"Under the business judgment rule there is no protection for directors who have made "an unintelligent or unadvised judgment." A director's duty to inform himself in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and its stockholders. Since a director is vested with the responsibility for the management of the affairs of the corporation, he must execute that duty with the recognition that he acts on behalf of others. Such obligation does not tolerate faithlessness or self-dealing. But fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information of the type and under the circumstances present here. Thus, a director's duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty. [...] In the specific context of a proposed merger of domestic corporations, a director has a duty under (the law), along with his fellow directors, to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders. Certainly in the merger context, a director may not abdicate that duty by leaving to the shareholders alone the decision to approve or disapprove the agreement. Only an agreement of merger satisfying the requirements of (the law) may be submitted to the shareholders".

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